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No. 94-2027

# In The Supreme Court

OF THE

# United States

OCTOBER TERM 1994

MONTGOMERY SECURITIES and PAINEWEBBER INC.,
*Petitioners,*
vs.
RICHARD B. DANNENBERG, *et. al.,* On Behalf of Themselves and all others Similarly Situated.
*Respondents.*

**On Petition For Writ Of Certiorari To The United States Court Of Appeals For the Ninth Circuit**

## MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMERICAN BANKERS ASSOCIATION, THE AMERICAN ELECTRONICS ASSOCIATION, THE ASSOCIATION OF PUBLICLY TRADED COMPANIES, THE NATIONAL ASSOCIATION OF MANUFACTURERS, AND THE SECURITIES INDUSTRY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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July 8, 1995

BOWNE OF PALO ALTO, INC. (415) 858-1800

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Pursuant to Rule 37.2 of the Rules of this Court, *amici,* the American Bankers Association ("ABA"), the American Electronics Association ("AEA"), the Association of Publicly Traded Companies ("APTC"), the National Association of Manufacturers ("NAM"), and the Securities Industry Association ("SIA"), respectfully move for leave

to file the attached Brief of *Amici Curiae* in Support of the Petition for Writ of Certiorari. Petitioners Montgomery Securities and PaineWebber Incorporated have consented to the filing of the brief. This motion is necessary because Respondents have denied consent.

The *amici,* non-profit trade associations, share a concern regarding the burdens imposed by vexatious litigation brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5. 17 C.F.R. § 240.10b-5. *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 739 (1975); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S. Ct. 1439, 1454 (1994). *Amici* have a substantial interest in limiting abusive litigation under the federal securities laws and in clarifying the standard of liability under Section 10(b), the most frequently invoked civil liability provision of the Exchange Act.

The ABA, a not-for-profit corporation, is the largest national trade association of the commercial banking industry in the United States. Member banks of the ABA are located in each of the fifty states and the District of Columbia. ABA members have been and are currently subject to claims under Section 10(b) implicating the questions presented in the petition for *certiorari.*

The AEA represents approximately 3,000 companies in 44 states, spanning the breadth of the electronics industry, including the semiconductor, software, computer, telecommunications, networks, and systems fields. Members of the AEA have been and are currently subject to claims raising the questions presented in the petition.

APTC's membership of more than 500 corporations includes the newest and smallest publicly traded firms as well as larger, more mature corporations. APTC represents its members' interests without regard to industry affiliation or

geographic location, and concentrates on issues of concern to publicly traded corporations. APTC members have been targets of Section 10(b) private securities fraud litigation. APTC members recognize from experience that the burdens imposed by vexatious securities fraud litigation can raise the cost of capital and divert resources from productive activity to nonproductive litigation-related matters.

The NAM is the nation's oldest and largest broad-based industrial trade association. Its more than 13,500 member companies and subsidiaries, including 10,000 small manufacturers, employ approximately eighty-five percent of all manufacturing workers and produce over eighty percent of the nation's manufactured goods. More than 158,000 additional businesses are affiliated with the NAM through its Associations Council and National Industrial Council. The NAM has a vital interest in the reasonable enforcement of the securities laws. The NAM believes spurious securities litigation has the potential to impact the competitiveness and profitability of all publicly traded businesses.

The SIA is the principal trade association of the securities industry. Its members include more than 700 broker-dealers and investment banking firms in the United States and Canada. When members of the SIA underwrite public offerings of securities that become the subject of class action lawsuits alleging claims under Section 10(b), they are often included among the parties named as defendants. Even when such litigation is ultimately found to be without merit, the litigation is expensive to defend and can injure defendants' reputation.

*Amici* submit that the decision of the court of appeals in this case raises a significant and recurring issue regarding the required mental state for violations of Section 10(b) and Rule 10b-5, and will subject defendants to unwarranted liability for innocent behavior. Many members of *amici* trade associations are located within the jurisdiction of the

Ninth Circuit and stand to be particularly affected by the decision below.

The issues presented by this case are of exceptional importance to *amici* and to their members. *Amici* seek to promote a consistent interpretation of the federal securities laws that retains fidelity to the statutory language and legislative history. *Amici* therefore respectfully seek leave of this Court to file the attached brief in support of the petition for writ of certiorari.

Respectfully submitted,

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## QUESTIONS PRESENTED

1. "[W]hether, in some circumstances, reckless behavior is sufficient for civil liability under" Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976) (reserving this question); *see also Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) (same).

2. If reckless behavior can, in some circumstances, suffice for implied civil liability under Section 10(b) and Rule 10b-5, what definition of "recklessness" establishes such liability?

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## INTERESTS OF *AMICI CURIAE*

This brief *amici curiae*, accompanied by motion for leave to file under Rule 37.2, is presented by the American Bankers Association, the American Electronics Association, the Association of Publicly Traded Companies, the National Association of Manufacturers, and the Securities Industry Association in support of the petition of Montgomery Securities and PaineWebber Incorporated for a writ of *certiorari* to review the decision of the United States Court of Appeals for the Ninth Circuit in this case.

As detailed in the motion accompanying this brief, this case is of great significance to the trade associations appearing as *amici*, as well as to their individual members. Members of *amici* trade associations have been subject to lawsuits that raise the specific questions presented for review in this case. Moreover, petitioners in this case are both members of *amicus* Securities Industry Association. A substantial volume of litigation raising the questions presented in this petition has arisen and will continue to arise in the Ninth Circuit.

## REASONS FOR GRANTING THE WRIT

The Petition for a Writ of Certiorari should be granted for three distinct reasons.

This Court has twice reserved the question of whether recklessness constitutes a state of mind sufficient to impose liability under the Section 10(b) implied private right of action. 15 U.S.C. § 78j(b). Neither the text, nor the structure, nor the legislative history of the statute support such liability. The petition should be granted so that this Court can correct the error below and establish that recklessness is not sufficient to establish liability under the implied Section 10(b) private right of action. The error below is not

unique and arises in a large number of cases across all Circuits.

Second, the Circuits are split over the definition of recklessness that supports implied private Section 10(b) liability and the Securities and Exchange Commission advocates a definition inconsistent with the approach adopted by the majority of Circuits. Confusing definitions and contradictory results abound. The petition should be granted so that, if this Court holds that recklessness suffices to establish Section 10(b) liability, this Court can articulate a uniform definition of recklessness.

Third, vexatious litigation under Section 10(b) imposes substantial costs on the economy. The financial risk inherent in securities fraud litigation can also force innocent defendants to enter into expensive settlement agreements. An interpretation of Section 10(b) that retains fidelity to the statutory text by requiring a showing of scienter — and not any lesser state of mind — will preserve the Securities and Exchange Commission's enforcement authority, deter vexatious litigation, and keep open the courthouse door to private party plaintiffs harmed by the conscious frauds against which Section 10(b) was designed to protect.

## ARGUMENT

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), this Court held that scienter is a necessary element of an implied private action for damages under Section 10(b) and Rule 10b-5. 17 C.F.R. § 240.10b-5. This Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 194 n.12. This Court has, however, twice reserved "the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id. See also Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) ("we have explicitly left open the

question whether recklessness satisfies the scienter requirement").

This Court's silence of nearly two decades has promoted substantial splits among the Circuits. These splits have spawned widespread confusion and fostered much litigation. More fundamentally, this Court's silence has allowed the lower courts to interpret Section 10(b) in a manner that is inconsistent with the text of the statute and that conflicts with its legislative history. The scope of liability for reckless conduct in an implied private right of action under Section 10(b) stands as a recurring and significant unanswered question in the interpretation of the federal securities laws. This petition presents a particularly felicitous opportunity to resolve that question.

## I. RECKLESS BEHAVIOR IS INSUFFICIENT FOR CIVIL LIABILITY UNDER THE IMPLIED § 10(b) PRIVATE RIGHT.

Section 10(b) "does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy. . . ." *Hochfelder*, 425 U.S. at 196. While the implied private right of action under Section 10(b) is "beyond peradventure," *Huddleston*, 459 U.S. at 380, the rationale for the right's existence has never been articulated by this Court.[1]

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[1]The Supreme Court recognized the implied § 10(b) private right of action "with virtually no discussion." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). The law governing the implication of private rights has changed substantially since the § 10(b) private right was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). Every rationale relied on by the lower courts in creating the implied right has since been repudiated by this Court, and there is substantial doubt that this Court would imply a private § 10(b) right of action for money damages if the issue presented itself on a clean slate. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action*

This Court has also "made no pretense that it was Congress' design to provide the remedy afforded" by the implied Section 10(b) cause of action,[2] and there is, at most, a congressional "acknowledgment of the Rule 10b-5 action without any further expression of legislative intent to define it."[3] Indeed, this Court has recognized a sea change

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*Under the Federal Securities Laws: The Commission's Authority*, 107 Harv. L. Rev. 961, 986-89 (1994).

[2] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 359 (1991). Accord, Brief for the Securities and Exchange Commission as *Amicus Curiae* Supporting Respondents at 24 n.32, *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (No. 93-404), reprinted in *The SEC Speaks in 1995* at 872, 895 n.32 (Practising Law Institute 1995).

[3] *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2089 (1993). "Congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction. . . ." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1453 (1994) (quotation omitted). The Senate has recently passed legislation that prescribes a pleading standard for § 10(b) private actions but specifically avoids any definition of the element of scienter required to establish a § 10(b) violation. S. 240, 104th Cong., 1st Sess. § 104(b) (June 28, 1995) (referring generally to private actions arising under the Securities Exchange Act that require proof that "defendant acted with a particular state of mind" without defining any such state of mind). *See also* 144 Cong. Rec. S 9171 (daily ed. June 27, 1995) (remarks of Senator Specter, sponsor of the amendment adopted as § 104(b), explaining that the amendment relates solely to pleading requirements). The House of Representatives has recently passed legislation that would expand the definition of scienter to include and define recklessness. H.R. 1058, 104th Cong., 1st Sess. § 4 (1995) (Mar. 12, 1995).

The uncertain potential for Congressional action — especially when the Senate bill preserves the questions presented for review — is not an impediment to the grant of the petition. This Court has very recently granted *certiorari* in cases raising questions that could be mooted by currently pending legislation. *See United States v. Chesapeake & Potomac Tel. Co. of Va.*, (No. 94-1893) and *National Cable Television Ass'n. v. Bell Atlantic Corp.*, (No. 94-1900) (presenting question of constitutionality of cross-ownership restrictions barring local telephone

in its approach to the interpretation of the implied Section 10(b) right and has emphasized that the implied nature of the right does not provide license to abandon "adherence to the statutory language." *Central Bank*, 114 S. Ct. at 1446.[4]

### A. Neither the Text Nor the Legislative History of Section 10(b) Support Liability For Reckless Behavior

"The starting point in every case involving construction of a statute is the language itself."[5] Because Congress "did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme," this Court has been forced "to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5

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companies from entering cable television business), *petitions for cert. granted*, 63 U.S.L.W. 3906 (U.S. June 27, 1995). *See also* S. 652, 104th Cong., 1st Sess. § 202 (June 15, 1995) (eliminating cable and telephone company cross-ownership restrictions). The securities bills passed by each chamber would, moreover, apply only to lawsuits filed after the legislation's effective date and would leave hundreds of pending cases alleging billions of dollars in damages to be resolved under incorrect and conflicting precedent.

[4] *See also Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102-03 (1991) (recognizing that *Cort v. Ash*, 422 U.S. 66, 78 (1975), and *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575 (1979), emphasize the importance of an inquiry into Congressional intent to authorize a private cause of action and that this emphasis on Congressional intent became clear only after the § 10(b) and § 14(a), 15 U.S.C. § 78n(a), implied private rights had been recognized by the Court).

[5] *Hochfelder*, 425 U.S. at 197 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). *See also Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1074 (1995) (Thomas, J., dissenting); *Central Bank*, 114 S. Ct. at 1446; *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977).

action been included as an express provision in the 1934 Act."[6]

The inference from the language of the statute is clear. Congress would not have created Section 10(b) liability for reckless behavior.

Section 10(b) prohibits "any manipulative or deceptive device or contrivance" in contravention of rules adopted by the Commission pursuant to Section 10(b)'s delegated authority. The terms "manipulative," "device," and "contrivance" "make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." *Hochfelder*, 425 U.S. at 199. The intent was to "proscribe *knowing* or *intentional* misconduct." *Id.* (emphasis supplied). In addition, the "use of the word "manipulative" is especially significant [because] [i]t is and was virtually a term of art when used in connection with securities markets. It connotes *intentional* or *willful* conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* (footnote omitted) (emphasis supplied).

A market cannot be manipulated in violation of the Exchange Act through inadvertence or with lack of subjective consciousness. Nor can one construct a device or contrivance absent subjective awareness. The words, "manipulative," "device," or "contrivance," by their very nature, require conscious intent and connote purposive activity.[7] The mental state consistent with the statute can be achieved

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[6] *Central Bank*, 114 S. Ct. at 1441-42 (quoting *Musick, Peeler*, 113 S. Ct. at 2089-90).

[7] *See Hochfelder*, 425 U.S. at 199 n. 20 ("device" means " 'that which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice' ") (quoting Webster's International Dictionary (2d ed. 1934)); *id.* (defining "contrivance" as " '[a] thing contrived or used in contrivance; a scheme,

only if a defendant acts with a state of mind "embracing" — an active verb — "intent" — requiring a conscious state of mind — "to deceive, manipulate or defraud."[8]

The legislative history compels the same conclusion. "[T]here is no indication that § 10(b) was intended to proscribe conduct not involving scienter." *Hochfelder*, 425 U.S. at 202; *see also Aaron v. SEC*, 446 U.S. 680, 691 (1980) (same). Indeed, "[i]n considering specific manipulative practices left to Commission regulation . . . the [Congressional] reports indicate that liability would not attach absent scienter, supporting the conclusion that Congress intended no lesser standard under § 10(b)." *Hochfelder*, 425 U.S. at 204. Congress thus "evidenced a purpose to proscribe only *knowing* and *intentional* misconduct." *Aaron*, 446 U.S. at 690 (emphasis supplied).

### B. The Structure of the Statute Underscores That There Is No Section 10(b) Liability for Recklessness

In drafting the federal securities laws, Congress knew how to use specific language to impose liability for reckless or negligent behavior and how to create strict liability for violations of the federal securities laws.[9] But Congress did not use such language to impose Section 10(b) liability on

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plan, or artifice," obviate . . . design; invent . . . to scheme' " (quoting Webster's International Dictionary (2d ed. 1934)).

[8] *Hochfelder*, 425 U.S. at 193 n.12. *Cf. Santa Fe Industries*, 430 U.S. at 478; *Schreiber v. Burlington Northern Inc.*, 472 U.S. 1, 5-8 (1985).

[9] Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, for example, imposes strict liability on the issuer for material misstatements or omissions in a registration statement and a "sliding scale" negligence standard on other participants in the offering process. *See Hochfelder*, 425 U.S. at 208. Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2),(3), impose liability for negligent or reckless conduct in the sale of securities. *Aaron*, 446 U.S. at 697.

reckless behavior. Therefore, just as there is no liability for aiding and abetting a violation of Section 10(b) because Congress knew how to create such liability but did not;[10] and just as there is no liability under Section 12(1) of the Securities Act, 17 U.S.C. § 77l(1) for participants who are merely collateral to an offer or sale because Congress knew how to create such liability but did not;[11] and just as there is no remedy under Section 10(b) for those who neither purchase nor sell securities because Congress knew how to create such a remedy but did not;[12] there can be no liability for reckless conduct under Section 10(b) because Congress clearly knew how to impose liability for reckless behavior but did not.

This Court has, moreover, emphasized that the securities laws "should not be read as a series of unrelated and isolated provisions."[13] The federal securities laws are to be interpreted consistently and as part of an interrelated whole.[14] In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), the Court reserved "the question whether scienter was necessary for liability under § 14(a)."[15] The Court nonetheless held that statements of "reasons, opinions or

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[10] *Central Bank*, 114 S. Ct. at 1448 ("Congress knew how to impose aiding and abetting liability when it chose to do so.") (citing statutes).

[11] *Pinter v. Dahl*, 486 U.S. 622, 650 & n.26 (1988) (Congress knew how to provide liability for collateral participants in securities offerings when it chose to do so).

[12] *Blue Chip*, 421 U.S. at 734. ("When Congress wished to provide a remedy for those who neither purchase nor sell securities, it had little trouble doing so expressly.") .

[13] *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1067 (1995).

[14] *See, e.g., Hochfelder*, 425 U.S. at 206 (*citing Blue Chip*, 421 U.S. at 727-30; *SEC v. National Sec.*, Inc., 393 U.S. 453, 466 (1969)).

[15] 501 U.S. at 1090 n.5 (*citing TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 n.7 (1976) (reserving the same question)).

belief" are actionable under § 14(a), 15 U.S.C. 78n(a), and Rule 14a-9, 17 C.F.R. § 240.14a-9, as false or misleading only if there is proof of (1) subjective "disbelief or undisclosed motivation," and (2) objective falsity. 501 U.S. at 1095-96. Justice Scalia explained the Court's holding as follows:

> As I understand the Court's opinion, the statement "In the opinion of the Directors, this is a high value for the shares" would produce liability if in fact it was not a high value and the Directors knew that. It would not produce liability if in fact it was not a high value but the Directors honestly believed otherwise. The statement "The Directors voted to accept the proposal *because* they believe it offers a high value" would not produce liability if in fact the Directors' genuine motive was quite different — except that it would produce liability if the proposal in fact did not offer a high value and the Directors knew that.[16]

It follows that,

> if: (A) a statement must be subjectively disbelieved in order to be actionable under Section 14(a), a provision that may or may not require scienter,
>
> then: (B) *a fortiori*, under Section 10(b), a provision that clearly requires scienter, plaintiffs must also show subjective disbelief.

Any other result would lead to the anomalous conclusion that statements actionable under Section 10(b), the more restrictive "catchall" provision of the federal securities laws, *Hochfelder*, 425 U.S. at 203, would not be actionable under Section 14(a). Indeed, "[t]here is no indication that Congress intended anyone to be made liable under [under § 10(b)] unless he acted other than in good faith [and]

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[16] 501 U.S. at 1108-09 (Scalia, J., concurring in part and concurring in the judgment).

[t]he catchall provision of § 10(b) should be interpreted no more broadly." *Id.* at 206.[17]

The language of the text, the legislative history, and the structure of the statute therefore each compel the conclusion that subjective knowledge is a prerequisite for liability under Section 10(b). Nevertheless, since *Hochfelder*, eleven of the twelve Circuits have held that various forms of conduct or inaction passing under the generic and ill-defined label of recklessness are sufficient for civil liability under Section 10(b).[18]

The question of whether Section 10(b) liability attaches to reckless behavior thus arises in a posture similar to that presented in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994). The petition in *Central Bank* was granted to "resolve the continuing confusion over the existence and scope of the § 10(b) aiding and abetting action." *Id.* at 1444. Prior to *Central Bank*, this Court had twice reserved that question in the very same cases reserving the questions presented in this case. *See Hochfelder*, 425 U.S. at 191-92 n.7; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983). In the wake of this Court's silence, eleven Courts of Appeal had recognized an implied Section 10(b) private right against aiders and abettors, and no Court of Appeals had denied the existence of such a right. *See Central Bank*, 114 S. Ct. at 1456 n.1 (Stevens, J., dissenting) (collecting cases). Notwithstanding lower court precedent, *Central Bank* held that there is no

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[17]This Court has previously extended holdings from § 14(a)'s proxy antifraud provisions to § 10(b)'s general antifraud provision. *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (adopting for purposes of § 10(b) liability the standard for materiality initially defined under § 14(a) by *TSC*, 426 U.S. at 445).

[18]*See, e.g.*, VIII Louis Loss & Joel Seligman, *Securities Regulation* 3665-67 n.521 (3d ed. 1991) (collecting cases).

implied private § 10(b) cause of action for aiding and abetting.

As was the case in *Central Bank*, the lower courts are in error. The lower courts define recklessness so as to impose liability even when there is no showing of the subjective, "knowing," "intentional," or "willful" intent "to deceive, manipulate or defraud" that is required by the statute. This petition provides an opportunity to correct the error below.

## II. IF RECKLESSNESS SUFFICES THEN THE PETITION SHOULD BE GRANTED TO RESOLVE A SPLIT AMONG THE CIRCUITS AND WITH THE S.E.C. REGARDING THE DEFINITION OF RECKLESSNESS.

The lower courts disagree among themselves and with the Securities and Exchange Commission over the proper definition of recklessness. If this Court ultimately concludes that recklessness suffices under Section 10(b), then the Court should resolve the conflict among the circuits by defining the precise contours of recklessness sufficient to establish implied private Section 10(b) liability.[19]

There is "little uniformity . . . among the circuits or even among different panels on the same circuit, on how proof of recklessness should be used to satisfy scienter."[20] The recklessness standards applied by the lower courts are described

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[19]The Court can, of course, avoid this difficult issue — just as it avoided the problem of defining the level of recklessness necessary to establish aiding and abetting liability under § 10(b) in *Central Bank* — by holding that recklessness will not suffice to establish liability.

[20]Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986).

as "highly indeterminate"[21] and "too amorphous."[22] More ominously, this ambiguity allows lower courts to adopt definitions that are "closer to negligence than the type of scienter the Court in *Hochfelder* and *Aaron* might have had in mind."[23]

While some courts apply a "barely reckless" standard, other courts lean toward a "highly reckless" standard.[24] Some courts speak of recklessness as "carelessness approaching indifference,"[25] while other courts look for "a lesser form of intent [rather] than merely a greater degree of ordinary negligence,"[26] and other courts claim to insist on a "more rigorous showing" of "severe recklessness."[27] The Securities and Exchange Commission recognizes the split among the Circuits and adds to the confusion by advocating its own definition of recklessness which conflicts with the dominant formulations applied by the courts below.[28]

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[21] James D. Cox, et al., *Securities Regulation: Cases and Materials* 740 (1991).

[22] 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 84 (2d ed. 1990).

[23] *Id.*

[24] *Id.* at 83.

[25] *Hoffman v. Estabrook & Co.*, 587 F. 2d 509, 516 (1st Cir. 1978).

[26] *Sanders v. John Nuveen & Co.*, 554 F. 2d 790, 793 (7th Cir. 1977), *cert. denied*, 450 U.S. 1005 (1981).

[27] *Cox, et al., supra* note 21, at 740 (quoting *Broad v. Rockwell Int'l. Corp.*, 642 F.2d 929, 961-62 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981)).

[28] The Brief of the Securities and Exchange Commission, *Amicus Curiae*, Regarding Rehearing En Banc at 15-24, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc) (No. 87-3837), reprinted in *The SEC Speaks in 1990* (Practising Law Institute 1990), recognizes the split and describes several of its dimensions. In that brief, the Commission advocates the "common law's conscious indifference

No Circuit better illustrates the confusion over the definition of recklessness than the Ninth which, for years, was notorious as a hotbed of conflicting definitions of recklessness.[29] In an effort to end this confusion, and over the objections of the Securities and Exchange Commission, an en banc court in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991), adopted as the Ninth Circuit's uniform definition of recklessness, the Seventh Circuit's *Sundstrand* standard, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

The *Sundstrand* standard has both an objective and subjective component. The objective component requires a showing of something more than "inexcusable negligence," 553 F. 2d at 1045 & n. 19, and demands that "the danger of misleading buyers . . . [is] so obvious that any reasonable man would be legally bound as knowing." *Id.* at 1045 n.20. The subjective component demands that "the omission must derive from something more egregious than even "white heart/empty head" good faith. *Id.* at 1045. Therefore, if a defendant "genuinely forgot to disclose information or that it never came to his mind" then there can be no finding of

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standard." The Commission also criticizes the Fifth and Eleventh Circuits for requiring a higher standard and challenges the Sixth Circuit for allowing a weaker standard. *Id.* at 15-16, 23. The Commission's proposed common law standard is, however, inconsistent with the *Sundstrand* standard which is "adhered to, albeit with some variation by a majority of the circuits," and the Commission's proposed definition was rejected by the Ninth Circuit. *Hollinger*, 914 F.2d at 1569.

[29] *See Hollinger*, 914 F.2d at 1569 (explaining that the Ninth Circuit had previously "declined to define recklessness" and instead "tried to delineate its contours"). This lack of definition allowed some panels to articulate "a standard of recklessness that is not clearly distinguishable from negligence." *Id.* (citations omitted). The lack of definition also allowed some panels to resort to a "flexible duty" standard that had been specifically rejected in *Hochfelder*. *See, e.g., id.* at 1570 n.11.

recklessness "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20; *see also id.* at 1047 ("an omission caused because [defendant] genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect") (citation omitted).

The Ninth Circuit's effort to achieve uniformity through *Sundstrand* has failed. Some Ninth Circuit panels properly require that both the subjective and objective components of *Sundstrand* be satisfied. For example, in *Kaplan v. Rose,* 49 F.3d 1363 (9th Cir. 1994), *petition for cert. filed,* 63 U.S.L.W. 3849 (U.S. May 10, 1995) (No. 94-1895), the court affirmed a grant of summary judgment in favor of defendants who submitted "declarations of good faith" where the only response by plaintiff was an assertion that the statements at issue "are so false that defendants must have known they were false and must have intended to mislead the public." *Id.* at 1379. As the panel explained, allegations that defendants "should have known" are insufficient to establish scienter on a motion for summary judgment. *Id.* at 1380.

In stark contrast, the panel below improperly applied a "half-*Sundstrand*" standard that ignores *Sundstrand's* critical subjective component. In particular, the panel found that "plaintiffs presented no evidence of the Underwriters' actual knowledge or fraudulent intent." (Petitioners' Appendix at A18). Summary judgment should then have been affirmed as to the issue of scienter because the subjective recklessness required by *Sundstrand* cannot exist in the absence of actual knowledge or fraudulent intent. Summary judgment was, however, reversed because the panel concluded that a jury could find that Petitioners "should have known" of the alleged fraud. (A16, A18). This "should have known" standard, however, constitutes nothing more than the objec-

tive form of "inexcusable negligence" that *Sundstrand* defines as insufficient to establish recklessness.

The danger of such a purely objective standard is clear. "The use of an objective test or formulation which makes a presumption of knowledge or intent on the part of the defendant comes very close to the legal formulations of negligence and gross negligence. In accordance with the decision in *Hochfelder,* however, honesty in fact and good faith would form complete defenses to liability.... Where an objective test is used, providing that the defendant should or must have known of the facts, it would seem to be in direct contradiction to a defense based on honesty in fact or good faith." 69A Am. Jur. 2d *Securities Regulation-Federal* § 1284, at 394 (1993).

This danger is realized by the decision below. The petition should be granted so that this Court can resolve the conflicts among the Circuits and among panels of the same Circuit, and articulate a definition of recklessness that more closely incorporates the standard of scienter compelled by the statute.

## III. POLICY CONSIDERATIONS SUPPORT GRANT OF THE PETITION.

The dangers of vexatious litigation under the implied private Section 10(b) cause of action are well known to this Court.[30] The uncertainty over Section 10(b) liability for reckless conduct compounds these dangers because it makes courts "reluctant to grant summary judgment in 10b-5

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[30]See, *e.g., Blue Chip,* 421 U.S. at 739 (litigation under § 10(b) "presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general"); *Central Bank,* 114 S. Ct. at 1454 (noting that these dangers force "secondary actors to expend large sums even for pretrial defense and the negotiation of settlements").

cases,"[31] and as long as a plaintiff can "prevent the suit from being resolved against him by dismissal or summary judgment" the plaintiff can extract a "settlement value . . . out of any proportion to [the case's] prospect[s] of success at trial."[32]

"Judge Friendly, who was not given to hyperbole, called settlements induced by a small probability of an immense judgment in a class action 'blackmail settlements.' " *In re Rhone-Poulenc Rorer Inc.*, 51 F. 3d 1293, 1298 (7th Cir. 1995) (*citing* Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973)). The federal securities laws are ripe for such "blackmail settlements" because defendants are generally unwilling to risk financial ruin on the outcome of a single trial.[33] The prospect of producing such settlements can also inspire plaintiff class action counsel to file strike suits in which the probability of a successful verdict is remote.[34] A clear articulation that liability under Sec-

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[31] 2 Hazen, *supra* note 22, § 13.4, at 85.

[32] *Blue Chip*, 421 U.S. at 740.

[33] *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 528-34 (1991); Douglas M. Schwab, *Congress, Corporations and Shareholder Class Actions*, The Recorder, Mar. 23, 1995, at 7 ("The fundamental reason [Rule 10b-5] cases are capable of abuse is that almost every one presents the risk of bankruptcy. . . . It is a rare board that will seek vindication in court and risk a jury verdict resulting in bankruptcy when the company can escape for less than $2 million of its own money [added to insurance proceeds]. So the case settles.").

[34] *See, e.g.*, Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2084-86 (1995) (describing plaintiff incentives to file strike suits in which "defense costs are far larger than those of prosecution"); Joseph A. Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727, 739-43 (1995) (collecting and analyzing data that compare litigation defense costs and the size of settlements in securities fraud actions).

tion 10(b) attaches only to conduct with scienter, and that recklessness does not constitute scienter, would enhance the chances for early dismissal of weak cases and reduce the incidence of Judge Friendly's "blackmail settlements."

A clear articulation that recklessness does not give rise to liability in implied private Section 10(b) litigation would also address the "ripple effects" generated by "uncertainty and excessive litigation" under Section 10(b).

> For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.[35]

Consistent with this Court's prediction, recent reports indicate that auditors are dropping ever larger numbers of clients because of the risk of securities fraud litigation. "New companies, which have a particularly high chance of failure, are affected most, because almost nothing triggers lawsuits against accountants faster than company failures."[36]

The mere suggestion that this Court grant a petition to consider the possibility that reckless behavior does not give rise to Section 10(b) liability may raise substantial concern among advocates of an expansive reading of the federal securities laws. These concerns are, however, easily exaggerated.

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[35] *Central Bank*, 114 S. Ct. at 1454.

[36] Lee Berton, *Big Accounting Firms Weed Out Risky Clients*, Wall St. J., June 26, 1995, at B1.

The Securities and Exchange Commission's enforcement program will be largely unaffected by any ruling in this case because the Commission will remain able to attack reckless and negligent behavior in the sale of securities under Sections 17(a)(2) and (3) of the Securities Act of 1933. 15 U.S.C. § 77q(a)(2),(3).[37] Private party plaintiffs will also remain able to pursue defendants whose conduct evinces "a mental state embracing intent to deceive." Moreover, many defendants who have been charged with serious forms of recklessness that satisfy *Sundstrand's* objective and subjective standards are likely to find that their conduct will also support an inference of scienter under *Hochfelder.* Indeed, in the wake of *Central Bank*, the Securities and Exchange Commission made clear that it and private party litigants will continue to prosecute as primary violations of Section 10(b) certain forms of conduct that had been traditionally denominated as aiding and abetting.[38] This

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[37] Sections 17(a)(2) and (3) reach negligence and recklessness in the sale, but not in the purchase, of securities. *Aaron*, 446 U.S. at 697. Section 10(b) addresses fraud in both the purchase and sale of securities. A holding that recklessness is not sufficient for liability under § 10(b) might therefore restrict the Commission's ability to pursue fraud in the purchase of securities to cases involving scienter, not recklessness. It is difficult to conceive of realistic scenarios in which a party perpetrates a fraud through the reckless, non-scienter based purchase — not sale — of securities, and we are unaware of any such prosecutions in recent years. Concerns over the Commission's enforcement program therefore seem more theoretical than real. The Court could, however, limit even this remote consequence by basing its holding solely on the implied nature of the private § 10(b) right and reserving for a later case the question of whether recklessness suffices in Commission enforcement proceedings under § 10(b).

[38] *See, e.g., Concerning the* Central Bank of Denver *Decision Before the Subcomm. on Securities of the Senate Comm. on Housing and Urban Affairs*, 103d Cong., 2d Sess. (1994) (testimony of Arthur Levitt, Chairman, SEC), *available in* LEXIS, Legis Library, Cngtst file; Diana Henriques, *Towers Investors Try Aggressive New Legal Tack,*

Court expected and invited such a response when it observed that the "absence of Section 10(b) aiding and abetting liability does not mean that secondary actors are always free from liability under the securities acts," and that such actors could be found liable as primary violators, "assuming *all* of the requirements for primary liability under Rule 10b-5 are met." *Central Bank*, 114 S. Ct. at 1455. Plaintiffs and lower courts are acting as this Court anticipated, and primary liability under Section 10(b) is being attached to parties who have traditionally been pursued as aiders and abettors.[39]

A holding that limits Section 10(b) liability to scienter and establishes that recklessness does not suffice will therefore preserve plaintiffs' rights to attack conduct that evinces conscious fraud of the sort that Congress intended to proscribe under Section 10(b). It will also promote the judiciary's ability to filter out weaker claims that are unable to establish the essential elements of "knowing" or "intentional" misconduct under the federal securities laws. This is precisely the category of claims that should be thrown out of court as inconsistent with statutory language and legislative intent and prone to the danger of vexatious litigation giving rise to "blackmail settlements."

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N.Y. Times, June 30, 1994, at D1; Tom Weidlich, *Professionals Still At Risk*, Nat'l L.J., July 18, 1994, at A6.

[39] *See, e.g., In re U.S.A. Classic Sec. Litig.*, No. 93 Civ 6667 (JSM), 1995 U.S. Dist. LEXIS 8327, at *13 (S.D.N.Y. June 19, 1995) (finding that plaintiffs' allegations were sufficient to establish primary liability and that the cause of action is not precluded by *Central Bank*). *See also* Edward Brodsky, *Aiding and Abetting Claims Under Rule 10b-5*, N.Y. L. J., June 14, 1995, at 3 (describing recent decisions in which traditional aiding and abetting activity has been attacked as a primary violation).

## CONCLUSION

For the foregoing reasons, *amici curiae* request this Court to grant the petition for a writ of certiorari.

Respectfully submitted,

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